



Theory and Reality: Arizona's Tax Structure


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Q: Desirable Properties

- ◆ If you had a blank sheet of paper – if you could start over – what criteria would you use to design the state's tax system?



Principles of Taxation


- ◆ Governing magazine, Febr. '03, *The Way We Tax: A 50-State Report*
 - Adequacy
 - Fairness
 - Management



Principles of Taxation

◆ Adequacy

- Generates enough money (both short and long term)
- Responds to structural changes in the economy
- Stable
 - Well balanced
 - Multiple sources
- Competitive
 - Doesn't deviate from other states



Principles of Taxation

- ◆ Adequacy
- ◆ Fairness
 - Similar taxpayers are treated equally
 - Taxpayers with greater ability to pay should pay more – avoid “regressive” structure
 - Minimal effect on economic decisions
 - Low rates, broad base
 - Minimize exemptions, which are distortionary



Principles of Taxation

- ◆ Adequacy
- ◆ Fairness
- ◆ Management
 - Accountability – simple, understandable, visible
 - Economical – low administrative & compliance costs
 - High voluntary compliance rates



Four-Star Rating System

- ★★★★ - not perfect, but stands out from the pack
- ★★★ - room for improvement but doing well
- ★★ - state could continue to function, but clear elements that could benefit from change
- ★ - needs dramatic reform



Arizona's Rankings – 2 Stars

- ★ ★ Adequacy
- ★ ★ Fairness
- ★ ★ Management



Analysis for Arizona

◆ Editors note:

- \$1 bill in tax cuts enacted since early 90's
- Alternative fuel tax rebate that cost rainy day fund
 - Approx. \$200 mill
- System more reliant on sales tax
- “Arizonan's have a visceral hatred of almost any new tax or higher tax”
- Voter initiative to require 2/3rds super majority to raise taxes
- DOR's outdated technologies



Major Types of Taxes

- ◆ Three-Legged Stool:
 - Consumption
 - Sales & use (transactions)
 - Income
 - Individual and corporate
 - Wealth
 - Real & personal property
 - Estate tax
 - Vehicle license tax



Each Tax Has Its Shortcomings

◆ Consumption

- “relying on the sales tax is like riding a horse that is rapidly dying”
- Today, we buy fewer products and more services
- Growth in Internet sales (difficult to collect tax due)
- No standardization across jurisdictions
- Hits low income households harder



Each Tax Has Its Shortcomings

◆ Property taxes

- Incredibly unpopular, large noticeable lumps
- Can be unfair if valuations not consistent
- Personal property tax (business equipment) hurts competitiveness
- Can hurt fixed income-elderly
- Heavily used by schools and counties
- Erosion of base
 - Enterprise zones
 - “Special deals” (recruitment, valuation methods)



Each Tax Has Its Shortcomings

◆ Income taxes

- “**Corporate** income taxes belong on the endangered species list”
- Apportionment formulas
- Hard to collect
 - Holding companies can shift income to subsidiaries in other states to avoid tax
- Popular financial incentive tool for recruiting new firms



Each Tax Has Its Shortcomings

- ◆ Income taxes
 - **Individual** income taxes second only to property tax as the most hated
 - Most of tax cuts during 1990s were here
 - Treats different kinds of income differently
 - Capital gains vs. wage income
- ◆ Estate tax -- limits are increasing



Two Fundamental Rules of Basic Finance

- ◆ Do not pay for ongoing expenses with one-time revenues
- ◆ Do not cut taxes permanently in response to transitory surges in revenues



Golden Rule of Tax Equity

- ◆ Collect the lowest possible rates on the widest possible base of taxpayers



Who Pays?

- ◆ Institute on Taxation and Economic Policy study of distributional aspects of tax systems in all 50 states
- ◆ “...most state and local tax systems take a much greater share of income from middle- and low-income families than from the wealthy... most state tax systems are *regressive*.”
- ◆ Fairness and ability to pay

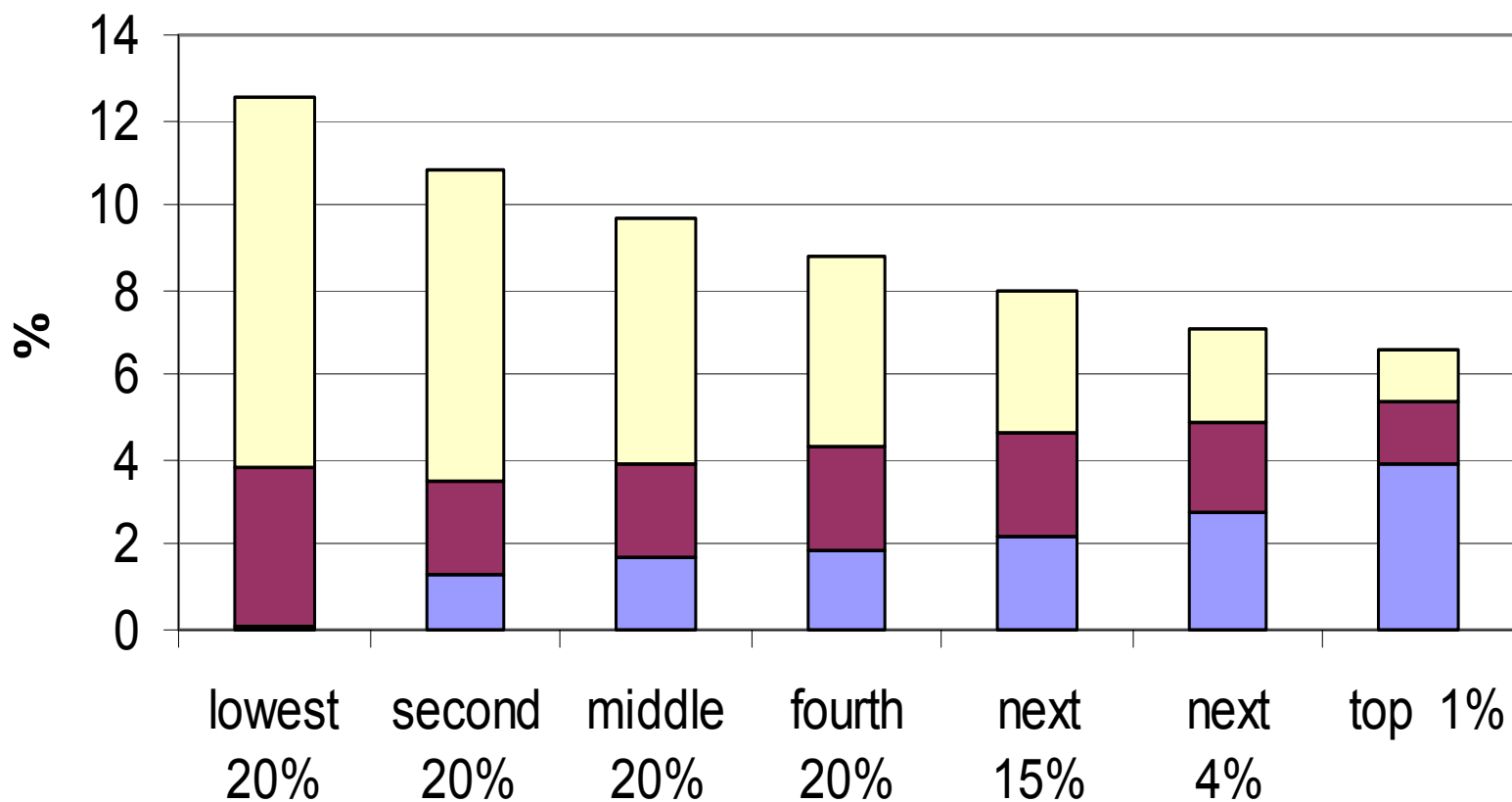


Who Pays?

- ◆ “Most states tax the wealthy at rates that are much lower than the rates on middle- and low-income families.”
- ◆ “...changes in state and local taxes over the past decade have made state tax systems even more regressive.”

State & Local Taxes in 2002, AZ

Income Property Sales & Excise





AZ Findings From “Who Pays?”

- ◆ AZ imposes one of the highest overall tax burdens on the poor (bottom 20%)
 - 12.5% effective rate is 7th highest nationally
 - 2nd among western states (WA is 1st)
- ◆ Tax burden on top 1% (4.9%) ranks 33rd
- ◆ AZ’s poor pay an effective tax rate that is 2.5 times that paid by the top 1%



What About Retirees?

- ◆ *Kiplinger's Retirement Planning 2002*
 - Affluent retired couple with HH income of \$60,000
 - AZ (PHX) ranks 17th lowest among 51 places with an effective tax rate of 4.9% of income
 - 5th lowest in the West
 - Paid all of \$479 income taxes to AZ, 18% below national average
 - Source: Public Finance in Arizona, ASU



How to Offset Regressivity

- ◆ Utilize the income tax with a graduated tax structure and shift tax mix toward income
- ◆ Utilize “means-tested credits”
 - “Earned income tax credits (EITC)”
 - Personal and dependent exemptions
 - Large “zero bracket” or standard deduction
 - Elderly, low income & renters property tax credit, homestead exemptions, “circuit breakers”
- ◆ Continue to tax capital gains
- ◆ Exempt groceries from sales tax
- ◆ Minimize the use of “excise taxes”



Did AZ Spend Too Much?

- ◆ Cato Institute study, *States Face Fiscal Crunch after 1990s Spending Spree*
 - Concludes that states spent too much when revenues were strong
 - Advocates an expenditure limitation capped by the sum of growth in population and inflation
 - BUT, this doesn't apply to AZ
 - from 1990-2001, AZ's tax revenue grew by 93%, population and inflation by 96%



Public Finance in Arizona

- ◆ Source: ASU College of Business
- ◆ “As a percent of personal income, revenues currently are the lowest since records began in FY 1971”
- ◆ The combined tax burden in AZ is below the national average... between 11 and 17%...and has dropped considerably since the early 1990s”
- ◆ “Per capita spending on operations in FY 2000 was 5th lowest, 19% below average”



Reasons for Current Deficits

- ◆ Tax cuts and narrowing of tax base
 - Since 1993, taxes were cut by \$1.2 billion
 - One-third of taxes collected in FY 92
 - Adjusting for inflation and population growth, \$1.8 billion *per year* no longer being collected
 - Property tax eliminated in 1996 – \$267 million
 - Sales tax exemptions of \$284 million



Reasons for Current Deficits

- ◆ Tax cuts and narrowing of tax base
 - Reductions in income taxes
 - Individual - \$870 million per year
 - Corporate - \$121 million per year
 - Current income tax credits
 - Individual - \$200 million per year
 - Corporate - \$100 million per year



Reasons for Current Deficits

- ◆ Tax cuts and narrowing of tax base
 - “Other taxes - \$237 million
 - (VLT, insurance premium, etc)
- ◆ Failure to adequately fund “BSF”
- ◆ Growth in demand for government



Conclusions

- ◆ Adequacy and fairness of AZ's tax system were significantly compromised during the past decade



Taxation Theory and Reality

- ◆ “There is probably no other field in which the distance between academic theory and what really happens on the street is so enormous.” – Governing magazine